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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal From The Court Of Appeal Of The State Of California For The First Appellate District

BRIEF *AMICUS CURIAE* OF THE CONFEDERATION OF BRITISH INDUSTRY

JOHN S. NOLAN
MILLER & CHEVALIER, CHARTERED
1700 Pennsylvania Ave., N.W.
Washington, D.C. 20006
(202) 626-5700
Counsel for Amicus Curiae
The Confederation
of British Industry

Of Counsel:
VICTOR THURONYI
MILLER & CHEVALIER, CHARTERED
1700 Pennsylvania Ave., N.W.
Washington, D.C. 20006

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BRIEF *AMICUS CURIAE* OF THE CONFEDERATION OF BRITISH INDUSTRY

QUESTION ADDRESSED BY AMICUS CURIAE

Should not this court explicitly recognize that the application of worldwide combined reporting to *foreign*-based multinational corporate groups presents considerations substantially different from those applicable to U.S.-based groups because of the heterogeneous economic and political conditions affecting such foreign groups?[1]

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[1] All parties have consented to the filing of this brief. Copies of the written consents have been lodged with the Clerk of the Court.

INTEREST OF AMICUS CURIAE

The Confederation of British Industry ("CBI") is an independent, non party-political body organized in the United Kingdom. Its members include industrial, commercial, and public sector companies; employer organizations and trade associations that represent individual manufacturing industries; and commercial associations. CBI directly represents some 14,000 corporate entities in Great Britain and some 100,000 more through affiliated trade and employer organizations. The Confederation speaks for businesses employing over ten million persons, one half of total employment in Great Britain outside of central and local Government.

A number of CBI's members own subsidiary companies in the United States. At the end of 1980, United Kingdom direct investment in the United States was $11.3 billion, about seventeen percent of total foreign investment in the U.S., making the U.K. the second largest foreign investor in this country.[2] CBI, on behalf of its members, thus has a substantial and direct interest in State taxation of affiliates of U.K. corporations. The worldwide combined reporting method has a direct and adverse impact on CBI's members with affiliates in the United States.

The worldwide combined reporting method used by a few States is fundamentally destructive of foreign investment in the U.S. and therefore of broader trade relationships between the United States and other countries. It is an arbitrary and extraterritorial method of taxation contrary to Due Process of Law. It intrudes directly upon the Constitutional responsibility of the Federal Government to regulate foreign commerce. It interferes with an existing uniform Federal policy which is in accord with the custom of nations.

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[2] *See* Bureau of Economic Analysis, U.S. Dep't of Commerce, *Survey of Current Business*, Aug. 1981, at 47.

CBI has actively opposed the use by some States of worldwide combined reporting and has sought to eliminate such discriminatory taxation as applied to U.K. corporate groups. In its testimony in 1977 at Senate hearings on ratification of the U.K. tax treaty, CBI strongly supported an article of the treaty negotiated by the two governments (Article 9(4)) that would have prevented States from including U.K. companies and their subsidiaries in a combined report unless they were controlled by a U.S corporation.[3] A majority of the Senate voted to maintain article 9(4) intact, but the necessary two-thirds majority for treaty ratification could not be obtained. Accordingly, article 9(4) was made inapplicable to the States by a protocol to the treaty (though it remains applicable to the Federal Government). So amended, the treaty was ratified by Parliament with great reluctance, and only after vigorous debate. Since then, the U.K. Government has continued to seek relief for U.K.-owned corporate groups from the excessive burdens imposed by worldwide combined reporting.[4]

SUMMARY OF ARGUMENT

In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979), this Court identified two requirements under the Commerce Clause for the validity of a State tax reaching foreign commerce. A State taxing scheme will be struck down if it "creates a substantial risk of international multiple taxation" or "prevents the Federal Government from 'speaking

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[3] *See* Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings Before the Senate Comm. on Foreign Relations, 95th Cong., 1st Sess. 184 (1977) (Statement of John S. Nolan on Behalf of the British National Committee of the International Chamber of Commerce and the Confederation of British Industry) [hereinafter cited as Senate Hearings].

[4] *See, e.g.*, British Embassy, Press Release, *reprinted in* Brief of Appellant, App. G., *Chicago Bridge & Iron Co.* v. *Caterpillar Tractor Co.*, No. 81-349 [hereinafter cited as *Chicago Bridge*].

with one voice when regulating commercial relations with foreign governments.' " As a threshold matter, the State tax must pass the four-part test set forth in *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977). One of the elements of that test is that the tax not discriminate against interstate or foreign commerce. Nondiscrimination is perhaps the most basic requirement that the Commerce Clause imposes. Finally, this Court's decisions establish that a taxing scheme which is arbitrary or extraterritorial violates the Due Process Clause. *See Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920); *ASARCO, Inc.* v. *State Tax Commission*, 50 U.S.L.W. 4962, 4964 (U.S. June 29, 1982).

This case presents the issue whether the worldwide combined reporting/unitary apportionment method of taxation ("worldwide method") applied by California violates the above standards. Before reaching this issue, this Court is presented with the question whether the operations of appellant and its subsidiaries constitute a unitary business. Under the elaboration of the unitary business test in this Court's recent decisions in *ASARCO, Inc.* v. *State Tax Commission*, 50 U.S.L.W. 4962 (U.S. June 29, 1982), and *F.W. Woolworth Co.* v. *Taxation and Revenue Department*, 50 U.S.L.W. 4957 (U.S. June 29, 1982), it seems clear that the operations of appellant's foreign subsidiaries do not constitute part of its unitary business. If this Court so finds, it will not, of course, have any occasion to reach the issues discussed in this brief.

In the case at bar, appellee Franchise Tax Board has applied the worldwide method to a multinational corporate group headed by a U.S. parent company. While the worldwide method violates the standards described above even when it is applied to a U.S.-based group, its constitutional violations are infinitely more severe when it is applied to a foreign-based

group.[5] This fact has been recognized by the Treasury Department.[6] This brief is designed to seek explicit recognition by this Court of the unique constitutional problems presented by application of the worldwide method to foreign-based corporate groups.

The worldwide method systematically overallocates income to the taxing States in the case of foreign-based groups. This effect is the key element in three constitutional violations. First, because it leads to taxation of income not earned in the taxing State, the worldwide method constitutes extraterritorial taxation in violation of the Due Process Clause. Second, because it leads to a higher average tax burden on foreign than on domestic commerce, the worldwide method discriminates against foreign commerce, in violation of the Commerce Clause. Third, by frequently subjecting to State taxation income that has already been taxed by the country in which it was earned, the worldwide method violates the Commerce Clause by leading to a substantial risk of international multiple taxation. These Due Process and Commerce Clause violations, while they may exist in any case of use of the worldwide method by the States, are extraordinarily severe when foreign-based companies are involved. Moreover, when applied to such companies, the worldwide method prevents the United States from speaking with one voice, in violation of the Commerce Clause test set forth in *Japan Line*.

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[5] As used in this brief, the terms "foreign-based multinational corporate group", "foreign-based group", and the like mean a group of corporations which are ultimately controlled by a parent company resident in a foreign country and owned predominantly by non-U.S. citizens.

[6] *See* State Taxation of Foreign Source Income: Hearing Before the House Comm. on Ways and Means on H.R. 5076, 96th Cong., 2d Sess. 7-8 (1980) (Statement of Assistant Secretary of the Treasury Donald C. Lubick).

ARGUMENT

I. Formula Apportionment Applied Internationally Is Inherently Arbitrary and Extraterritorial, Thus Violating the Due Process Clause.

This Court has upheld formula apportionment in the domestic[7] context on a number of occasions. *E.g.*, *Exxon Corp.* v. *Wisconsin Dept. of Revenue*, 447 U.S. 207, 221-223 (1980). Recently, the Court stated that "[a]lthough separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 438 (1980). This approval of formula apportionment makes practical sense in the domestic context. The considerations justifying the use of apportionment as a substitute for arm's-length accounting do not, however, apply when the task is to distinguish foreign from domestic income.

First, it is crucial to recognize that the "separate accounting" rejected by this Court in *Mobil*, *Exxon*, and earlier cases is quite different from the arm's-length accounting information available in the international context. The principal distinction is that, internationally, arm's-length accounting is policed by the Internal Revenue Service. It would not be possible in this context for a company to provide different "separate accounting" analyses to different States, since the company would be bound by the information furnished to the IRS. Moreover, the States would benefit from IRS audits of income according to the arm's-length rules, just as they benefit from other IRS audit adjustments.[8] Accordingly, international arm's-length rules lead to a much more accurate sourcing of income than can be obtained from separate accounting in the domestic context.

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[7] A case in which apportionment was applied to both foreign and domestic operations did not present for consideration the issues of distortion and discrimination presented here. *See Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission*, 266 U.S. 271 (1924).

[8] *See* L. Hale & R. Kramer, State Tax Liability and Compliance Manual 46-47 (1981).

In addition, application and audit of international arm's-length rules are much more practicable than would be the use of such rules in domestic separate accounting. Domestic separate accounting would require that extensive interstate operations of a unitary business in a number of States be untangled State by State. By contrast, in the international context, the only transactions that must be tested according to arm's-length rules are those between a U.S. company and related foreign companies. The numerous transactions that a typical multinational group carries out entirely among its United States corporate members or entirely abroad need not be examined, since they would not affect the division of income between U.S. and foreign sources. Worldwide combined reporting stands in stark contrast to the relatively narrow scope of arm's-length accounting, since it requires consideration of *all* income-producing transactions of all members of the corporate group thoughout the entire world, together with the property, payroll, and sales of such members in all parts of the world.

Second, the homogeneity of the U.S. economy and the nearly universal use of very similar apportionment formulas by the States assure that apportionment of U.S. income will work fairly. Profits will in most cases bear a reasonably close relationship to the apportioning factors; and, where they do not, the excess apportioned to one State will be compensated by a lesser amount of income apportioned to other States. When applied in the international economy, however, the formula apportionment method is "inherently arbitrary," *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920), and is consequently impermissible under the Due Process Clause.

Thus, because of the divergence of economic conditions throughout the world, profits generally will not bear the same relationship to the apportionment factors in different countries. Intercountry differences can often be ascribed directly to government policy, which, by the very nature of government, will vary significantly from country to country. For example, a high level of indirect taxes on the products sold by a company in

a given country will artificially inflate the sales factor in that country. Profits as a proportion of total sales will be less than they are in low-tax countries and worldwide apportionment will, therefore, over-allocate profits to the country with higher indirect taxation. The Windfall Profit Tax produces this effect, resulting in the over-allocation of worldwide oil income to the United States.

The same will be true of the property factor in the case of a country that imposes stringent pollution controls or other production regulations that increase the cost of a company's investments without increasing profits. This Court may take judicial notice of the fact that California imposes far more severe environmental control requirements than most of the rest of the world.

In the case of the payroll factor, differing levels of employer taxes and minimum wages will, for example, lead to similar distortions. The United States, and particularly States such as California, tend to have far higher wage rates than elsewhere in the world, due in part to such regulations and taxes.

Given these types of realities, it is inherently arbitrary and irrational to allocate profits according to a formula applied to different countries in the same manner, without any recognition of these differences.

As suggested above, and as shown more particularly in Part II below, the worldwide apportionment method results, on average, in an excessive allocation of profits to the United States. It therefore leads, on a systematic basis, to State taxation of income that is not earned within the taxing State. Such extraterritorial taxation constitutes an additional violation of the Due Process Clause. *See ASARCO, Inc.* v. *State Tax Commission*, 50 U.S.L.W. 4962, 4964 (U.S. June 29, 1982).

II. The Worldwide Method Violates the Commerce Clause Because It Discriminates Against Foreign Commerce, and Does So Even More Seriously When Applied to a Foreign-Based Group.

A. *The Worldwide Method Discriminates Against Foreign Commerce.*

In addition to being an impermissibly arbitrary and extraterritorial method of taxation, in violation of Due Process, the worldwide method violates the Commerce Clause because it discriminates against foreign commerce. This discrimination comes about when a State goes beyond the arm's-length income of the taxpayer to reach income earned by the taxpayer's foreign affiliates. Consider, for example, a U.K. corporation desiring to establish a subsidiary to do business in California. If California's taxing scheme has the effect, as it does, of including as taxable profits in California profits of other parts of the U.K. corporate group not carrying on business in California, or even the United States, then the California subsidiary will be taxed on a figure in excess of its own profits.[9] By contrast, a corporation operating in California alone will generally face a lighter tax load, since its tax base necessarily includes only the profits of the California corporation itself.

"No State, consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business.' " *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318, 329 (1977), *quoting Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 457 (1959). Where a State law on its face appears to be neutral as between local and interstate business, it is necessary to go beyond the letter of the statute and to inquire whether *its practical effect* is to

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[9] Whether a particular California taxpayer is so taxed will depend on the allocation factors adopted and the income of various members of the corporate group. We show below that the worldwide method, as applied to most multinationals, has the effect of overstating the income of subsidiaries operating in the taxing States.

discriminate against interstate business. *See Best & Co.* v. *Marshall*, 311 U.S. 454 (1940); *Hunt* v. *Washington State Apple Advertising Commission*, 432 U.S. 333, 348-53 (1977); *Exxon Corp.* v. *Governor of Maryland*, 437 U.S. 117, 145-48 (1978) (Blackmun, J., concurring in part and dissenting in part). If the worldwide method taxes most multinational corporations on amounts in excess of their arm's-length income earned in the United States, then it discriminates against foreign commerce, because the tax imposed is greater than that placed on domestic corporations.

The appellee has effectively admitted that the worldwide method has this effect. Mr. Kenneth Cory, as Chairman of the Franchise Tax Board and Controller of the State of California, stated that the estimated annual revenue loss to California from prohibition of the worldwide method was $125 million (in 1975 dollars).[10] A number of other States have recently confirmed that they would lose substantial revenues if arm's-length accounting were mandated.[11] If the worldwide method

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[10] *See Senate Hearings*, *supra* note 3, at 95, 167.

[11] Seven states responding to a questionnaire distributed by the Multistate Tax Commission on behalf of the Treasury Department furnished revenue loss estimates as follows: California: $500 million; Colorado: $12 million; Idaho: $16-17 million; Montana: $3 million; New York: $75 million; North Dakota: $3.5-5.5 million; and Utah: $16 million. *See* Multistate Tax Commission, *Summary of State Responses to Treasury Department Questionnaire on Use of Unitary Method and Taxation of Dividend Income* 5 (May 11, 1982). The questionnaire further asked the States to estimate what percentage of corporate taxpayers subject to the worldwide method suffered an increase in taxable income as a result of application of the method. The three States that provided a numerical estimate responded as follows: California: 75-85 percent; Colorado: probably 90 percent; and North Dakota: approximately 75-85 percent. *See id.* 5-6. Three States provided an estimate of the revenue loss that would result from denial of the worldwide method for foreign-based companies alone: California: $50 million (10 percent of the $500 million total revenue loss); Montana: $400,000 (13 percent of the total); and North Dakota: $500,000-$1,500,000 (14 to 42 percent of the total).

resulted in apportioning to the United States an amount of income equal, on average, to the income actually earned in the U.S., there would be no revenue loss from the use of arm's-length accounting as opposed to worldwide apportionment.[12] The necessary implication of the estimates of substantial revenue losses is that the worldwide method, as applied to most taxpayers, reaches income that, according to arm's-length accounting, is earned outside the State. As explained above, this means that foreign commerce is discriminated against.

Estimates by the States that the worldwide method produces substantially more revenue than arm's-length accounting are corroborated by statistics that show a substantial divergence in average wage costs between the U.S. and other countries. Except for a handful of European countries, average wage costs are lower throughout the world than in the United States.[13] There is uncontradicted testimony in the record below that these lower costs are associated with higher profit rates abroad. In general, the expected and actual return on investment is lower in the United States than in other countries, particularly less developed countries. *See* R.T. 9-47. An important reason why multinationals seek higher rates of return outside the United States is the riskiness of investing in countries with governments that are less stable than government in the United States. Because of the greater profits per

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[12] These revenue losses cannot be ascribed by the States to alleged manipulation of international transactions by the companies involved and inability of the States to police the arm's-length method. The companies involved in virtually all instances are large publicly-held companies which are intensively audited in their international transactions by the Internal Revenue Service. The financial statements of such companies are audited by independent certified public accountants, and differences between the financial statements and Federal corporate income tax returns are identified on the returns.

[13] *See, e.g.*, Brief of Appellant at 41 n. 13, *Chicago Bridge, supra;* Brief of National Association of Manufacturers as Amicus Curiae 6-7 (Table I), 8 (Table II), *Chicago Bridge, supra.*

unit of property, payroll, and sales in foreign countries, the worldwide apportionment method generally understates the income attributable to operations abroad.

Similarly, over-allocation occurs because of the income base to which worldwide apportionment is applied. Taxable income by U.S. standards differs very substantially from income as determined in the balance of the world in ways that tend to over-allocate income to the U.S. in the case of foreign-owned groups. The U.S. income base, generally adopted by States such as California, allows special deductions such as the Accelerated Cost Recovery System, percentage depletion, the LIFO inventory convention, and other allowances for economic or social reasons, as opposed to pure income measurement. While a U.S.-owned group may be able to convert its worldwide operations to U.S. income tax standards, a foreign-owned group simply cannot do so as a practical matter. The foreign group may have hundreds of foreign subsidiaries operating in scores of foreign countries with accounting personnel completely unfamiliar with these unique U.S. tax allowances. The foreign-owned group ends up having its allocated worldwide income consist of—(1) its worldwide income earned outside the U.S. determined from its financial statements (determined without all of the foregoing allowances), plus (2) its U.S. income determined by U.S. tax standards (with all of such special allowances). The result inevitably is an over-allocation of worldwide income to States in the U.S.

Another such example arises with respect to international oil operations. Many oil-producing countries require payment of enormous "taxes" at rates far in excess of customary corporate income tax rates. These taxes substitute for, or are economically equivalent to, economic rents for the use of land and mineral rights owned by these governments. The United States has complex provisions to limit the foreign tax credit for

these payments.[14] The exactions, though royalties to some extent in substance, are imposed by the foreign government as taxes and generally are not deductible in determining taxable income for State income or franchise tax purposes. Since most of the world's oil production is now outside the United States, particularly in the case of foreign-owned oil companies, the result of worldwide apportionment is severely to over-allocate income to States of the U.S.

The effective taxation of income earned by related foreign corporations resulting from the worldwide method also creates a substantial risk of international multiple taxation, in violation of *Japan Line*. Where the income has already been taxed by the country where it was earned, imposition of a State tax creates an impermissible multiple tax burden.

As described in Sections B-D below, the worldwide method results in a greater degree of overtaxation and imposes more severe compliance burdens when applied to foreign-based groups. The considerations described below are relevant in determining whether the taxing scheme results in sufficiently systematic and severe discrimination against foreign commerce to be invalidated. This case on its facts does not present the additional burdens peculiar to foreign-based groups. Accordingly, if this Court should find to any extent that the worldwide method as applied to U.S.-based groups does not discriminate against foreign commerce, the Court should explicitly recognize that such finding does not preclude a contrary determination with respect to foreign-based groups because of their differing circumstances.

B. *The Overtaxation of Foreign-Based Groups Is Much More Severe.*

The majority of the operations of U.S.-based multinationals are located in the United States. Conversely, most of the operations of foreign-based multinationals are located

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[14] *E.g.*, I.R.C. § 907.

abroad.[15] This is a critical distinction. The smaller U.S. presence of foreign-based firms heightens the degree of discrimination when the worldwide method is applied to them. For example, assume that foreign factors are, on average, ten percent too low,[16] and that a U.S.-based group has two-thirds of its factors here, the converse being the case for a foreign-based group. On these rather conservative assumptions, the discrimination against foreign commerce is *twice* as severe when the worldwide method is applied to a foreign-based group.[17]

C. *The Compliance Burden Is Much Greater for Foreign-Based Groups.*

It is well established that States may tax the domestic operations of U.S. corporations on the basis of apportionment formulas that take property, payroll, and sales in the various States into account. Because U.S.-based multinationals must therefore in any event maintain property, payroll, and sales data

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[15] For only 32 of the 195 U.S.-based companies listed in Table A of *The World Directory of Multinational Enterprises* did overseas subsidiary sales account for 40 percent or more of worldwide sales (see Table B of the *Directory*). On average, sales of overseas subsidiaries of those of the 430 *Directory* firms that are based in the U.S.A. were about 33 percent of worldwide sales in 1978 (Table 13). On average, total sales of subsidiaries outside the home country were 51 percent of world-wide sales for Canadian-based companies and 42 percent for European-based companies in 1978. Sales of U.S. subsidiaries were necessarily some fraction of these latter amounts. *See* J. Stopford, J. Dunning & K. Haberich, *The World Directory of Multinational Enterprises* (1980).

[16] In other words, assume that profits per unit of property, payroll, and sales are ten percent higher abroad than in the United States.

[17] Suppose that a U.S.-based group earns $200 at home and $110 abroad. Its property, payroll, and sales are each 200 at home and 100 abroad. Under the arm's-length method, the group's U.S. income is $200. Under the worldwide method, two-thirds of the group's total $310 income would be apportioned to the U.S., namely $206.67. U.S. income is therefore overstated by $6.67, or 3.33 percent. The reason

with respect to their domestic operations, which, as noted above, generally constitute a majority of total operations, extension of the apportionment formula to include their worldwide operations does not usually create an extraordinary additional compliance burden. By contrast, application of worldwide formula apportionment imposes a tremendously costly, if not impossible, record-keeping burden upon most foreign multinationals, because worldwide property, payroll, and sales data would not otherwise have to be developed. Even if some of these data had to be developed for other purposes, they would not generally be expressed in U.S. dollars or according to U.S. accounting principles. Restatement of any property, payroll, and sales data maintained by member companies of a foreign-based group is often a massive undertaking. Development of the property factor, which must be based on historic cost at historic exchange rates of all assets in service, can be well-nigh impossible.[18]

A corporate group controlled by a U.S. parent maintains consolidated financial statements in U.S. dollars and according to U.S. accounting principles in reporting to its shareholders.

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for the overstatement is that foreign profits per unit of property, payroll, and sales are ten percent greater than in the U.S.

Now consider a foreign-based group with the same ten-percent differential in profitability per unit of property, payroll, and sales. It earns $100 in the U.S. and $220 abroad, and its property, payroll, and sales are each 100 in the U.S. and 200 abroad. The worldwide method allocates one-third of the group's total $320 income, or $106.67, to the United States. This is an overstatement of the group's U.S. income of 6.67 percent, compared with the 3.33-percent overstatement in the case of the U.S.-based group. Thus, the degree to which U.S. income is overstated is twice as great for the foreign-based group.

[18] Development of the property factor would require translating the original acquisition cost of each asset owned by members of the multinational group into U.S. dollars at the exchange rates prevailing on the date of acquisition and recomputing depreciation to date on this basis.

The SEC requires public disclosure of these data.[19] In addition, information returns setting forth the income of foreign subsidiaries must be filed with the IRS.[20] Some of this income may be directly taxable to the U.S. parent as "Subpart F" income[21] and, accordingly, all of such income is subject to IRS audit.

Any such data maintained by a foreign-based multinational will, however, be based on foreign accounting principles and will be expressed in foreign currency. Currency translation poses extraordinarily burdensome problems. Because of the fluctuation of currency rates over the course of a year, a simple translation of the bottom-line amount into U.S. dollars will not correctly express the dollar equivalent of income earned by different subsidiaries with differing taxable years in a number of foreign currencies. In practical terms, the impossibility in many cases of making the required currency and accounting adjustments forces foreign-based groups to use book income figures in the apportionment formula. As noted above,[22] this severely disadvantages foreign-based taxpayers.

U.S. subsidiaries of foreign-based companies often experience extreme difficulties in obtaining the information necessary to comply with the worldwide method. When a State imposes the worldwide method on a U.S. parent, the parent can order its subsidiaries to provide the required data. By contrast, a U.S. corporation controlled by a foreign parent may be unable to convince its parent and sister foreign corporations to develop the extensive data needed to compute the tax of the U.S. subsidiary under the worldwide method. A request for information by a U.S. subsidiary may be rejected by its foreign parent, especially where the request is in aid of a method of taxation contrary to internationally accepted principles of

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[19] *See* 17 C.F.R. § 210.3-02.

[20] *See* Internal Revenue Service Form 3646.

[21] *See* I.R.C. §§ 951-964.

[22] P. 12.

taxation. The foreign parent may even be prohibited by foreign law from disclosing the information, as when the information relates to a defense contract.[23]

If a U.S. subsidiary is unable to obtain the required information, the taxing State should not be allowed to penalize it for the inaction of the related foreign corporations. Provided that these corporations do not do business in the United States, the State would under these circumstances have no jurisdiction to compel them to produce the required documents. *E.g., In re Grand Jury Subpoenas*, 72 F. Supp. 1013, 1019 (S.D.N.Y 1947). The prospect of such jurisdictional challenges to a State's request for information reveals the essentially extraterritorial nature of the worldwide combined reporting method as applied to foreign-based groups.

D. *The Additional Burdens Imposed on Foreign-Based Groups Cannot Be Justified by Legitimate Interests of the States.*

The additional burdens imposed by the worldwide method cannot be justified by difficulties in administering the arm's-length method, as the States argue in relation to U.S.-based groups. Thus, in the case of U.S.-based multinational groups, the States contend that even sophisticated policing of the arm's-length standard fails to take fully into account the intangible and elusive benefits provided by the parent company to its subsidiaries, such as technical know-how, managerial services, and centralized information. Omission of a proper charge for such benefits understates the income of the parent company. The overstatement caused by the worldwide method may compensate for this omission to some degree. When the worldwide method is applied by a State to a U.S. subsidiary of

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[23] In the *EMI* case, disclosure of information relating to defense contracts was sought by California but was protected from disclosure by the U.K. Official Secrets Act. *See* Appellant's Opening Brief 5-6, *EMI Limited* v. *Bennett*, No. 80-4114 (9th Cir.).

a foreign-based group, however, this element of compensation for an omitted arm's-length charge is entirely absent. Indeed, omission of a charge for intangible benefits provided by the foreign parent *overstates* the income of the U.S. subsidiary as computed on an arm's-length basis.[24]

Similarly, while a U.S.-controlled group may often sell products produced by it in whole or in part in the United States to subsidiaries in foreign countries with low income tax rates, both less developed countries and countries such as Switzerland or Panama, so that the policing of intercompany transactions may be of major importance, this is ordinarily not the case with respect to a foreign-based group with a U.S. subsidiary. Foreign groups operating in the U.S. are generally selling products produced by them either in the U.S. or in their home country, an industrialized nation, such as the U.K., Canada, Japan, West Germany, France, Italy, or Sweden, which are countries that also have high corporate income tax rates. In such instances, a foreign-based company generally has no incentive to seek to allocate profits to its home country as opposed to the United States. Moreover, both the home country and the U.S. Internal Revenue Service carefully monitor the arm's-length pricing of intercompany transactions. As noted above,[25] the resulting audit information is available to the States.

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[24] If a foreign parent were to *overcharge* for services, the transaction would be out in the open and could be audited according to arm's-length rules. The problem for arm's-length auditing occurs when there is no charge at all, in which case the transaction would leave no paper trail for an auditor.

[25] P. 6.

III. Worldwide Combination Involving Foreign Multinationals Prevents the United States From "Speaking With One Voice."

A. *Foreign Protests Demonstrate That the Worldwide Method Is a Very Serious Irritant to International Relations.*

Individual States prevent the United States from speaking with one voice to foreign countries when their actions invite protests and the possibility of retaliation by foreign governments. A number of trading partners of the United States have recently voiced strong complaints as to State use of the worldwide method.[26] Retaliation against U.S. companies has been discussed in Parliament as a possible response to use of the worldwide method by the States.[27] It is noteworthy that these protests have been confined to application of this method to U.S. subsidiaries of corporate groups based in the foreign country involved.[28] Article 9(4) of the proposed U.S.-U.K.

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[26] *See* Brief of Appellant at Appendices E (E.E.C.), F (Italy), G (U.K.), H (Netherlands), I (France), J (Canada), *Chicago Bridge, supra*. The Government of The Kingdom of the Netherlands has also filed a memorandum as amicus curiae in *Shell Petroleum, N.V.* v. *Graves*, No. C 81-4302 (N.D. Cal. 1981).

[27] *See* 22 Hansard, Parliamentary Debates (House of Commons) 823-28 (27 April 1982).

[28] *See* Brief of Appellee at 24-27, *Chicago Bridge, supra*.

For example, a Note presented to the State Department by the British Embassy on behalf of the ten EEC Governments stated: "Our Governments are concerned about the application to U.S. subsidiaries of foreign companies of the unitary basis of taxation . . ." British Embassy, Note No. 211 (30 October 1981), *reprinted in* Memorandum for the United States as Amicus Curiae at 4a, 5a, *Chicago Bridge, supra*.

A Note from the Canadian Embassy referred to "the so-called 'unitary tax apportionment' method used by certain States of the United States to allocate income to Unites States offices and subsidiaries of non-United States international companies. The Canadian Government continues to be of the view that this method results

Income Tax Treaty forbidding the worldwide method was likewise confined to U.S. subsidiaries of U.K. companies.[29]

It is self-evident why a foreign country is concerned when a State in effect taxes a U.S. subsidiary not only on its own income but also on non-U.S. income of other members of the corporate group based in that foreign country. Even though the subsidiary is in the first instance responsible for payment of the tax, the foreign parent suffers a direct harm by reason of the reduction in the value of its investment. When applied to a foreign-based group, the burden of the worldwide method accordingly falls on the foreign parent corporation and its foreign shareholders.

Foreign outrage at the worldwide method has already seriously interfered with the Federal Government's treaty negotiation process. The worldwide method has been an issue in several recent treaty negotiations, including treaties with the U.K., France, and Canada.[30] In the case of the U.K. treaty, after the Senate had failed to prohibit use of the worldwide method by the States, the United States made a number of concessions in the Third Protocol to the treaty to induce the U.K. to accept the treaty without this restriction.[31] The impact of concessions of this type is naturally not limited to the particular States employing the worldwide method, but falls on U.S.

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in inequitable taxation and imposes excessive administrative burdens on non-United States international companies doing business in those States." Canadian Embassy, Note No. 692 (Dec. 22, 1981), *reprinted in id.* 8a.

[29] An earlier version of this article would have forbidden inclusion of any U.K. company (or a subsidiary of a U.K. company) in worldwide combination, even if the parent were not U.K. based, but the U.K. Government gave up this point, its chief concern being with the taxation of U.K.-based multinationals.

[30] *See* Brief of Appellant, at App. G, I, J, *Chicago Bridge*, *supra*.

[31] *See id.* App. K.

citizens in all the States. It is axiomatic that action by individual States that places the Nation at a disadvantage in its relations with other Nations cannot be constitutionally tolerated.

B. *Uniform Federal Policy Established by Treaty Precludes Contrary State Action.*

Under the Commerce and Supremacy Clauses, State legislation is constitutionally pre-empted where Federal uniformity is required or where Congress has occupied the field by a comprehensive regulatory scheme. *E.g.*, *Campbell* v. *Hussey*, 368 U.S. 297, 300-03 (1961). In *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434, 451 (1979), this Court established that a State taxing scheme is subject to more exacting constitutional scrutiny if it impinges on foreign—as opposed to interstate—commerce. Applying this scrutiny, the Court found that the existence of treaties provided evidence of the need for Federal uniformity. In that case, a State property tax on containers used in foreign commerce was struck down. The United States was a party to the Customs Convention on Containers, which granted such containers duty-free entry. In addition, the U.S.-Japan Income Tax Treaty exempted from tax income derived from the use of such containers. The Court found the Customs Convention reflective of a national policy to remove impediments to the use of containers in international commerce, and struck down the California tax as violative of this policy. 441 U.S. at 453. In so doing, the Court relied on the fact that the California tax created "an asymmetry in international maritime taxation operating to Japan's disadvantage." *Id.* Japan did not tax American-owned containers. *Id.*

In this case, the expression of Federal policy and the consequent need for uniformity are even stronger than in *Japan Line*. With one understandable exception, all of the bilateral income tax treaties in force between the United States and other countries would prevent the United States from doing

what California seeks to do here.[32] This uniform Federal policy is echoed by the practice and policy of other countries and international organizations. It is beyond cavil that the scheme employed by a handful of States, headed by California, creates an "asymmetry" in the international scheme of business taxation.

Federal policy preventing worldwide apportionment is uniformly embodied in the income tax treaties of the United States, in substantially identical terms in each. These provisions have been part of this country's income tax treaty scheme for fifty years, ever since the first income tax treaty signed by the United States.[33] For example, the Income Tax Treaty, Dec. 31, 1975, United States-United Kingdom, art. 7, para. 1, 60 Stat. 1377, 1381, T.I.A.S. No. 1546, prevents the United States from taxing the income of a U.K. corporation unless the corporation has a "permanent establishment" in the United States. "Permanent establishment" means a fixed place of business. A subsidiary corporation may be, but is generally not, a permanent establishment of the parent. If the U.K. corporation does have a permanent establishment, the United States is restricted to taxing the profits "attributable" to the permanent establishment. The profits attributable to the permanent establishment are "the profits which it might be expected to make if it were a distinct and separate enterprise

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[32] The U.K. treaty is discussed below. The provisions of the remaining 24 treaties which prevent application of the worldwide method to a U.S. subsidiary of a foreign parent are listed at Appendix A. The one exception is the treaty with the Soviet Union. The Senate Foreign Relations Committee Report on that treaty noted that it omitted many of the standard provisions found in other income tax treaties. "It is probable that this difference is attributable to the contrasting political and economic systems of the two countries. U.S.S.R. nationals are not permitted to hold investments in foreign countries. . . ." Sen. Exec. Rep. No. 19, Tax Convention with U.S.S.R., 94th Cong., 1st Sess. (1975), *reprinted in* 1976-2 C.B. 467, 468.

[33] *See* Income Tax Treaty, United States-France, April 27, 1932, art. IV, T.S. 885, 49 Stat. 3145.

engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment." Art. 7(2). This is an expression of the arm's-length standard.

Thus, if a U.K. corporation operated in the United States through a permanent establishment such as a branch, the United States would clearly be prevented by treaty from taxing the branch according to formulary apportionment. If the permanent establishment took the form of a subsidiary corporation, the same result would obtain. The United States could tax only the profits properly attributable to the subsidiary, namely its arm's-length income. Finally, if the subsidiary were *not* a permanent establishment of the parent, and the parent had no permanent establishment in the United States, the United States could not tax the subsidiary on any of the income of the parent. Such taxation would violate the basic rule that the income of a foreign corporation that has no permanent establishment in the United States is exempt from United States tax. Formulary apportionment that resulted in taxing to the subsidiary an amount in excess of its arm's-length income would constitute such a violation.[34]

The uniform Federal policy precluding State use of the worldwide method is also evidenced by the numerous treaties of Friendship, Commerce, and Navigation ("FCN treaties"). In general, the FCN treaties prohibit imposition on foreign companies or their U.S. subsidiaries of taxes or compliance requirements that are unreasonable or more burdensome than those imposed on U.S. corporations. These treaties also prohibit taxation of U.S. subsidiaries on the basis of income in excess of that reasonably allocable to such corporations under

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[34] This result is reinforced by art. 9(4) of the U.S.-U.K. Treaty. This article was originally intended to apply to the States, but such application was withdrawn when the U.S. Senate refused to accept it. The article's prohibition of combined reporting, even though superfluous in light of article 7, was retained in a form applicable to the U.S. and the U.K. but not to their political subdivisions.

internationally-accepted principles.[35] The FCN treaties apply directly to the States, and they prohibit worldwide combined reporting as applied to subsidiaries of companies headquartered in countries with which the United States has entered into an FCN treaty. The United States has not entered into an FCN treaty with the United Kingdom. Although U.K. companies cannot therefore directly rely on an FCN treaty, the combination of the FCN and income tax treaties constitutes a pervasive scheme of Federal regulation of the taxation of U.S. subsidiaries of foreign companies that precludes inconsistent State taxing schemes, such as the worldwide method, with respect to companies of all foreign countries.

The uniform Federal policy expressed in the tax and FCN treaties is in complete harmony with the international acceptance of the arm's-length standard as the proper method of taxation. *See generally* Organization for Economic Cooperation and Development, *Transfer Pricing and Multinational Enterprises* (Paris, July 1979). In sum, the Federal government would violate its treaty obligations and contravene internationally accepted principles of tax administration if it adopted the unitary method with regard to foreign-based multinational groups. Both our treaty partners and the Treasury Department have stated that application of the worldwide method to foreign-based groups by the States violates the spirit of our income tax treaties.[36] Under *Japan Line*, such State creation of "an asymmetry in the international tax structure," 441 U.S. at 450, may not be tolerated.

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[35] *E.g.*, Treaty of Friendship, Commerce and Navigation, March 27, 1956, United States-Kingdom of the Netherlands, art. I, VI, XI, 8 U.S.T. 2043, T.I.A.S. No. 3942.

[36] *See* Brief of Appellant, at App. L-1, L-3, *Chicago Bridge*, *supra* (Letter from Treas. Sec'y William Simon to Senator Burdick); *id.* at App. M-1, M-8 to 9 (Statement of Asst. Sec'y Laurence N. Woodworth).

IV. Conclusion.

In deciding the case at bar, this Court should explicitly recognize the distinctions between U.S.-based and foreign-based multinationals. If this Court were to decide that the unitary method may in some cases be constitutionally applied to U.S.-based corporate groups, the opinion of the Court should very clearly indicate that it does not prejudice a challenge to this taxing scheme on the part of foreign-based groups.

When presented with a foreign-based taxpayer, the Court will properly have before it the question whether the worldwide method may constitutionally be applied to such a taxpayer and, further, whether, if such application is invalid, the statute should be struck down altogether or should be considered severable. Severability is a question of State statutory construction, not Federal law, so the answer may vary according to the State taxing scheme. *See Dorky* v. *Kansas*, 264 U.S. 286, 290 (1924). *E.g.*, *Chaplinsky* v. *New Hampshire*, 315 U.S. 568, 572 (1942). In the case of California, it seems clear that if this Court holds that the worldwide method may not be applied to foreign-based groups, such holding would not affect the applicability of such method to U.S.-based groups. *See* Cal. Rev. & Tax. Code § 23057 (Deering 1975).

Respectfully submitted,

JOHN S. NOLAN
Counsel for The Confederation of British Industry

Dated: July 31, 1982.

(Appendix follows)

APPENDIX A

The United States has income tax treaties in force with twenty-six countries. All but one of these treaties prohibit the United States from taxing the profits of a foreign corporation unless the corporation has a "permanent establishment" in the United States. In addition, certain treaties, designated herein as Type 1 treaties, limit the United States to taxing income attributable to the permanent establishment, plus in some cases certain related income. This limitation requires a determination of what income is attributable to the permanent establishment. These treaties uniformly specify that the standard for determining the amount of income that is attributable to the permanent establishment is the *arm's-length* standard. They are listed below, and the articles that limit taxation to the income of a permanent establishment and define such income according to the arm's-length standard are referenced.

The other type of treaty, which we designate as Type 2, allows the United States to tax a corporation's entire income derived within the United States, provided that the corporation has a permanent establishment here. There is thus no occasion to define what income is attributable to the permanent establishment. These treaties do, however, mandate use of the arm's-length standard for allocating income between related corporations. In the case of Type 2 treaties, also listed below, the referenced articles are those that prohibit U.S. taxation of a foreign corporation that does not maintain a permanent establishment in the United States; and that mandate the arm's-length standard in determining the incomes of related taxpayers.

In sum, all the income tax treaties currently in force, with the exception of the U.S.-U.S.S.R. treaty, embody the arm's-length standard.

Type 1

Income Tax Treaty, October 25, 1956, United States-Austria, art. II, III, para. 2, 8 U.S.T. 1699, 1701, T.I.A.S. No. 3923.

Income Tax Treaty, July 9, 1970, United States-Belgium, art. VII, para. 1, 2, 23 U.S.T. 2687, 2695, T.I.A.S. No. 7463.

Income Tax Treaty, March 4, 1942, United States-Canada, art. I, III, para. 1, 56 Stat. 1399, 1400, T.I.A.S. No. 1983.

Income Tax Treaty, March 6, 1970, United States-Finland, art. VIII, para. 1, 2, 22 U.S.T. 40, 53 T.I.A.S. No. 7042.

Income Tax Treaty, July 28, 1967, United States-France, art. VI, para. 1, 2, 19 U.S.T. 5280, 5282, T.I.A.S. No. 6518.

Income Tax Treaty, July 22, 1954, United States-Germany, art. III, para. 1, 2, 5 U.S.T. 2768, 2778, T.I.A.S. No. 3133.

Income Tax Treaty, February 20, 1950, United States-Greece, art. III, para. 1, 2, 5 U.S.T. 47, 57, T.I.A.S. No. 2902.

Income Tax Treaty, February 12, 1979, United States-Hungary, art. VII, para. 1, 30 U.S.T. 6361, 6369, T.I.A.S. No. 9560.

Income Tax Treaty, May 7, 1975, United States-Iceland, art. VIII, para. 1, 2, 26 U.S.T. 2004, 2042, T.I.A.S. No. 8151.

Income Tax Treaty, May 21, 1980, United States-Jamaica, art. VII, para. 1, 2, T.I.A.S. No. 10206, 10207.

Income Tax Treaty, March 8, 1971, United States-Japan, art. VIII, para. 1, 2, 23 U.S.T. 967, 982, T.I.A.S. No. 7365.

Income Tax Treaty, June 4, 1976, United States-Korea, art. VIII, para. 1, 2, 30 U.S.T. 5253, 5272, T.I.A.S. No. 9506.

Income Tax Treaty, April 29, 1948, United States-Netherlands, art. III, para. 1, 2, 62 Stat. 1757, 1758, T.I.A.S. No. 1855.

Income Tax Treaty, October 8, 1974, United States-Poland, art. VIII, para. 1, 2, 28 U.S.T. 891, 904, T.I.A.S. No. 8486.

Income Tax Treaty, December 4, 1973, United States-Romania, art. VII, para. 1, 2, 27 U.S.T. 165, 174, T.I.A.S. No. 8228.

Income Tax Treaty, March 25, 1939, United States-Sweden, art. II, III, 54 Stat. 1759, 1760, T.I.A.S. No. 5656.

Income Tax Treaty, January 9, 1970, United States-Trinidad and Tobago, art. VIII, para. 1, 2, 22 U.S.T. 164, 173, T.I.A.S. No. 7047

Income Tax Treaty, December 13, 1946, United States-Union of South Africa, art. V, para. 1, art. VII, 3 U.S.T. 3821, 3826, T.I.A.S. No. 2510

Income Tax Treaty, April 16, 1945, United States-United Kingdom, art. VII, para. 1, 2, 60 Stat. 1377, 1381, T.I.A.S. No. 1546

Type 2

Income Tax Treaty, May 14, 1953, United States-Australia, art. III, para. 2, 4, 4 U.S.T. 2264, 2267, T.I.A.S. No. 2879.

Income Tax Treaty, September 13, 1949, United States-Ireland, art. III, para. 1, 2, 2 U.S.T. 2303, 2307, T.I.A.S. No. 2356.

Income Tax Treaty, March 30, 1955, United States-Italy, art. III, para. 1, 3, 7 U.S.T. 2999, 3004, T.I.A.S. No. 3679.

Income Tax Treaty, March 16, 1948, United States-New Zealand, art. III, para. 1, 3, 2 U.S.T. 2378, 2382, T.I.A.S. No. 2360.

Income Tax Treaty, July 1, 1957, United States-Pakistan, art. III, para. 1, 3, 10 U.S.T. 984, 987, T.I.A.S. No. 4232.

Income Tax Treaty, May 24, 1951, United States-Switzerland, art. III, para. 1, 3, 2 U.S.T. 1751, 1755, T.I.A.S. No. 2316.